in the

UNITED STATES COURT OF APPEALS
For the Ninth Circuit

No. 21535

Peter Raich and
Wanda J. Raich,
Petitioner - (Appellant),

vs.

Commissioner of Internal
Revenue,
Respondent - (Appellee).

Appeal from the
Tax Court of
the United States

Honorable
Graydon G. Withey
Judge

Appellant's Brief

Clarence J. Ferrari, Jr.
300 West Hedding Street
San Jose, California

Attorney for Petitioner - Appellant

INDEX TO BRIEF

LIST OF AUTHORITIES CITED

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

NO. 21535

PETER RAICH AND WANDA J. RAICH

v.

COMMISSIONER OF INTERNAL REVENUE

ON APPEAL FROM THE TAX COURT OF THE UNITED STATES

BRIEF FOR APPELLANT

JURISDICTIONAL STATEMENT

This is an appeal from a decision of the Tax Court of the United States entered on August 15, 1966, determining deficiencies in Appellants' income tax for the taxable years 1961 and 1962. Appellants have timely filed a petition for review of the Decision of the Tax Court and this Court's jurisdiction is based upon 26 U.S.C. 7482.

STATEMENT OF THE CASE

This appeal is taken for the purpose of reversing the decision of the Tax Court of the United States which was submitted to the said Tax Court on the basis of a complete

stipulation of all material facts and documentary evidence. The Court below filed an opinion, findings of fact and conclusions of law and an order for judgment under which Appellants' prayer for relief was denied.

A summary of the pertinent facts is as follows:

On January 3, 1961, Peter Raich, one of the Appellants herein, transferred to Pete Raich Sheetrock Taping Service, Inc. all of the assets and liabilities of a sheetrock and drywall contracting business that he had conducted for many years as a sole proprietorship. For accounting purposes, the sole proprietorship had as its taxable year the calendar year and operated and employed the cash basis method of accounting for tax purposes. (R. 84)

The total assets transferred to the corporation amounted to $88,613.39, of which $77,361.66 were represented by trade accounts receivable. The accounts receivable had not been reported as income by the sole proprietorship but were reported as income by the corporation in the fiscal years in which they were collected. The liabilities assumed by the corporation amounted to $45,992.81 of which $37,719.78 was represented by trade accounts payable which were in existence as of the date of the transfer. None of the accounts payable were deducted for income tax purposes by the sole proprietorship, but were deducted by the corporation in the period in which they were paid. In exchange for the transfer, the Appellants received 2,500 shares of Ten ($10.00)

Dollar par value common stock valued at $25,000.00 and an unsecured promissory note in the face amount of $16,280.58. (R. 85, 86)

The Commissioner of Internal Revenue asserts that Appellants must report, as taxable income, the excess of the amount of liabilities assumed by the corporation over the "adjusted basis" of the assets transferred by Appellants to the corporation. In support of his assertion, the Commissioner of Internal Revenue contends that the "adjusted basis" of the assets transferred to the corporation is $11,251.73. In making this computation, the Commissioner maintains that a zero basis should be assigned to the accounts receivable. In support thereof, the Commissioner cites Section 357(c) of the Internal Revenue Code of 1954. (R. 86-89)

SPECIFICATION OF ERRORS RELIED UPON

1. The Tax Court erred in construing Section 357(c) of the Internal Revenue Code of 1954 as applying to the transfer of Appellants' sole proprietorship to Appellants' controlled corporation in a transaction which qualified under Section 351 of the Internal Revenue Code as a tax-free exchange.

2. The Tax Court erred in determining that trade accounts receivable in the hands of the cash basis taxpayer have a zero basis for purposes of determining the "adjusted basis of property transferred" under Section 357(c).

3. The Tax Court erred in not determining that accounts payables are not "liabilities" within the meaning of Section 357(c).

SUMMARY OF ARGUMENTS

The Commissioner of Internal Revenue seeks in this case to apply Code Section 357(c) to the incorporation of a cash basis taxpayer. The Commissioner's entire case is dependent upon his contention that the trade accounts receivable of a cash basis taxpayer should be assigned a zero basis for the purpose of determining whether or not Section 357(c) is applicable to a transaction which qualifies as a tax-free exchange under Section 351. The Tax Court agreed with the Commissioner that Section 357(c) is applicable and that the accounts receivable of a cash basis taxpayer should be assigned a zero basis for purposes of this section. The Appellants submit that Section 357(c) is not applicable to Appellants' transfer insomuch as the legislative history of the section and the language of the section itself clearly indicates that the section was not intended to apply to the transfer by a cash basis taxpayer of accounts receivable and accounts payable to a controlled corporation. The Tax Court, recognizing that its application of Section 357(c) to such transfers will hinder and limit the incorporation of cash basis businesses, concluded that it was compelled to so hold by the language of Section 357(c) itself. Appellants submit that not only was the section not

intended by Congress to apply to such a transaction but, further, that the language of the section itself is unclear when applied to cash basis methods of accounting and therefore, this language must be interpreted in accordance with the well-established intent of Congress to permit tax-free exchanges.

Appellants further submit that even if Section 357(c) is applicable to Appellants' transfer of accounts receivable and accounts payable, there is no logical basis for the contention by the Commissioner of Internal Revenue that accounts receivable should be assigned a zero basis and that accounts payable should be valued at their face amount for purposes of the Section 357(c) computation. The only logical application of this section would assign a tax basis to the accounts receivable equal in amount to the value of the accounts payable or, alternatively, to assign to the accounts payable the same basis that is assigned to the accounts receivable under the Commissioner's contention. The Appellants' argument must necessarily be sustained in view of the fact that accounts receivable and accounts payable to a cash basis taxpayer are treated in the same manner under the tax laws, i.e., accounts receivable are not recognized until they are collected and accounts payable are not recognized until they are paid. Therefore, the position of the Tax Court that accounts receivable and accounts payable should be treated differently for purposes of Section 357(c) is completely untenable.

ARGUMENT

I.

SECTION 357(c) OF THE INTERNAL REVENUE CODE OF 1954 WAS NOT INTENDED TO APPLY TO THE TRANSFER BY A CASH BASIS TAXPAYER OF ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE WHERE THE TRANSFER QUALIFIES AS A SECTION 351 EXCHANGE.

On January 3, 1961, Appellant, Peter Raich, transferred the assets of his contracting business to a corporation controlled by him and formed for the purpose of receiving the assets and assuming the liabilities of that business.(1) The Tax Court found that the transaction qualified under Section 351 but that "a literal interpretation of Sections

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(1) The assets and liabilities transferred to the corporation were as follows:

Assets		
Cash		$ 1,045.40
Trade accounts receivable		77,361.66
Receivables		1,833.97
Prepaid rent		125.00
Equipment	$13,626.30	
Less: Accumulated depreciation	5,378.94	8,247.36
Total		$88,613.39
Liabilities		
Trade accounts payable		$37,719.78
Notes payable		8,273.03
Total		$45,992.81

351(a)(1) and 357(c) compels the application of Section 357(c) to the transaction in question". The application of Section 357(c) in the instant case results in a tax being extracted in a situation which could not have been contemplated when Congress enacted that section. Its application to cash basis taxpayers in general will greatly hinder tax-free incorporation and will encourage distortions in the transfers of cash basis businesses to controlled corporations. Recognizing this clear misapplication of Section 357(c), the Tax Court summarized its decision by stating:

> "In applying Section 357(c) to the facts herein, we are not unmindful that the result reached may conflict with the well-established intent of Congress to foster tax-free business reorganizations. However, in the absence of a clearly expressed congressional intent, we decline to adopt a construction of Section 357(c) which is supported neither by its language nor its legislative history."

Appellants will show herein that, contrary to the holding of the Tax Court, both the legislative history and the language of the section itself clearly supports their position.

A. The legislative history of Section 357(c), viewed in light of this Court's decision in Easson is sufficiently clear to support Appellants' position.

This case is one of first impression. Subsection 357(c) is entirely new in the 1954 Code and has no counterpart in any prior Internal Revenue Code. Subsection 357(c) provides as follows:

"(c) Liabilities in Excess of Basis.--
(1) In General.--In the case of an exchange--
(A) to which section 351 applies, or
(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D)

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

Nowhere in the legislative history of Section 357(c) is the purpose for its enactment revealed.[2] It is therefore necessary to examine the theory and purpose of Sections 351[3] and 357, subparagraphs (a) and (b), as they existed prior to the enactment of subsection (c) of Section 357.

Until the decision in the United States v. Hendler, 303 U.S. 564 (1938), the problem of the assumption of liabilities in a reorganization had not been considered. In Hendler, the Supreme Court held that the assumption of liabilities in an otherwise tax-free reorganization would be treated as the equivalent of the payment of cash to the transferor and taxable to the extent of any

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(2) See H. Rept. 1337, 83rd Cong. (1954), 3 U.S.C. Cong. & Admin. News (1954) and S. Rept. 1622, 83rd Cong. (1954), 3 U.S.C. Cong. & Admin. News (1954).

(3) Section 351(a) provides that no gain or loss shall be recognized on the exchange of property for stock or securities in a controlled corporation. However, Section 351(d)(1) contains a cross reference to Section 357 where the transferee assumes liabilities or acquires property subject to liabilities.

gain realized. Thereafter, Section 112(k) of the 1939 Internal Revenue Code was enacted to overrule the Hendler result and this section was subsequently re-enacted without major change in Sections 357(a) and (b) of the 1954 Code.[4] In order to property characterize the problem which Section 357(c) was intended to cure, one must necessarily examine the problems which arose under Subsections 357(a) and (b) and their predecessor. Those subsections provide generally that where it

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(4) Sec. 357. Assumption of Liability.

Sec. 357(a) General Rule.- Except as provided in subsections (b) and (c) if--

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

Sec. 357(b) Tax Avoidance Purpose--

(1) In General.- If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)--

(a) was a purpose to avoid Federal income tax on the exchange, or

(b) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, 371, or 374 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of Proof-- In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

appears that the principal purpose of the taxpayer with respect to the assumption of liability in a reorganization is the avoidance of Federal income tax and if such purpose is not a bona fide business purpose, such assumption should be considered as money received upon the exchange. The situation which arose most frequently under the cases involved the transfer of mortgaged property. Where the theory underlying the enactment of Section 357(a) and (b) is applicable, the Courts have had little difficulty.(5) The reasoning of the courts in these cases is best expressed in Woodsam Associates, supra:

> "It is clear that there will not be a mere postponement of taxation, but possibly a complete tax exemption, if gain on the exchange in question is not presently recognized to the extent that the mortgage to which the transferred property was subject exceeded the petitioner's adjusted basis. (emphasis added)"

The purpose of Section 351 is to permit tax postponement. The purpose of Section 357(b) is clearly to prevent tax avoidance. It is submitted that the only logical explanation of Section 357(c) is to prevent tax avoidance in those situations not covered by Section 357(b). The most forceful authority for this proposition is the decision by this Court in Jack L. Easson v. Commissioner, 294 Fed.2nd 653 (9th Cir., 1961). This Court recognized in Easson that Congress had not foreclosed in 357(a)

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(5) See Crane v. Commissioner, 331 U.S. 1 (1947); Parker v. Delaney, 186 Fed.2nd 455 (1st Cir., 1950), Cert. denied, 341 U.S. 926 (1951); Woodsam Associates, Inc. v. Commissioner, 198 Fed.2nd 357 (2nd Cir., 1952)

and 357(b) all opportunities for tax avoidance. It correctly held that Section 112(k), the predecessor to Sections 357(a) and (b) did not apply to the transaction in question. The transaction was therefore nontaxable under Section 112(b)(5) which was the predecessor to Section 351. In Easson, the taxpayer transferred real estate valued at $320,000.00 subject to a mortgage of $247,000.00 to his controlled corporation. The property transferred had an adjusted basis in the hands of the taxpayer of $87,000.00. The Tax Court concluded that unless a tax was imposed on the transfer, the taxpayer would receive a windfall since the stock acquired would receive a basis of zero under Section 113(a)(6). This Court, however, sanctioned the concept of a "negative basis" as the only logical alternative to the Tax Court's holding in view of the clear language of Section 112.(6) Most importantly, this Court went on to state that:

> "The taxpayer's case on this point is bolstered by the fact that 1954 Code contains a provision specifically covering the situation presented by this case. Section 357(c) of the 1954 Code expressly provides that if the transferred property is subject to liabilities which exceed the transferor's basis in the property then the excess is to be presently recognized as gain." (emphasis added)

This Court recognized in Easson that Section 357(c) must necessarily be directed at the problem not solved by Section 357(b) -- the problem of a "negative basis" for

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(6) See Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1962)

stock received in a tax-free exchange. The enactment of Section 357(c) clearly eliminates the need to resort to the concept of "negative basis" as a means of preventing the avoidance of tax in cases involving mortgaged property. This construction of the statute is the only construction consistent with the example found in the Senate Finance Committee Report No. 1622, 83rd R. D. Long., 2nd Sess. (1954) at page 270:

> "Subsection (c) provides that if an exchange to which §351 (relating to a transfer to a corporation controlled by the transferor) is applicable or to which §361 (relating to the nonrecognition of gain of loss to corporations) is applicable by reason of a §368 (a) (1)(D) reorganization, if the sum of the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as gain from the sale or exchange of the capital asset or property which is not a capital asset, as the case may be. Thus, if an individual transfers, under §351, property having a basis in his hands of $20,000, but subject to a <u>mortgage</u> of $50,000 to a corporation controlled by him, such individual will be subject to tax with respect to $30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor." (emphasis added)

It is submitted that the only logical conclusion with respect to the legislative history of 357(c) is that set forth in the decision of this Court in <u>Easson</u>.

B. <u>Since the transaction in the case at bar does not involve tax avoidance, to apply Section 357(c) to cash basis taxpayers who transfer accounts receivable and accounts payable</u>

will necessarily result in double taxation and will encourage distortions in the incorporation of a cash basis business - results which could not have been intended by Congress.

The avoidance of tax necessarily presupposes that the transferor has received some economic benefit. While the Tax Court ostensibly conceded that no economic benefit was realized by the Appellants, it held that it was bound to literally interpret the statute. However, it is well settled that the literal interpretation of a statute must necessarily be modified by a reasonable construction which will avoid unwarranted results. (See Mertens, Law of Federal Income Taxation, Section 3.04, Zimet Revision). As will be seen below, unless this Court distinguishes between the application of 357(c) to a cash basis taxpayer who transfers accounts receivable and accounts payable to a controlled corporation and the application thereof to a transferor on the accrual basis, such unwarranted results must necessarily follow.

It is clear that the doctrine which evolves from the mortgaged property cases applies equally to both cash basis and accrual basis taxpayers. In all of the cases decided to date under Section 357(c), namely, Arthur L. Kniffen, 39 T.C. 533 (1965); N.F. Testor v. Commissioner, 40 T.C. 273, aff'd, 327 Fed.2nd 788 (7th Cir. 1964) and, most recently, Peter W. DeFelice, 25 T.C.M. 835 (1966); the question of mortgages was not involved. However, in each of those cases, the transfer of an insolvent business was involved since in

each case the liabilities assumed by the transferee corporation exceeded the value of the assets transferred. Although the Commissioner is relying heavily on these cases in the case at bar, they are clearly distinguishable. In the cases cited, the Commissioner made no attempt to assign a basis other than book value to accounts receivable and accounts payable. There was no need for the Commissioner to attempt to do so, since in each case there was clear economic benefit to the transferor inasmuch as the liabilities assumed by the transferee exceeded not only the adjusted tax basis of the assets transferred, but also their fair market value. Further, in all three cases, the fair market value of the assets transferred was at least equal to the adjusted tax basis under the various taxpayers' method of accounting. Clearly, Section 357(c) was properly applied in each of the aforementioned cases in order to prevent tax avoidance. Unless a tax had been imposed at the time of the transfer then, under Section 358, the taxpayer's basis for the stock received from the corporation would have had to have been reduced below zero by the amount that the liabilities assumed exceeded the basis of the assets transferred. This is the "negative basis" concept discussed in Easson. In Easson, of course, this Court recognized that 357(c) solved the problem of the negative basis.

The cases relied on by the Commissioner are inapplicable to the instant case. The facts of this case can be simplified by assuming that the accounts receivable were the only assets

transferred and the accounts payable were the only liabilities assumed. The Commissioner, in his determination of deficiency assigned a zero basis to the accounts receivable, valued the accounts payable at their face amount and concluded that the accounts payable exceeded the adjusted basis of the accounts receivable and, therefore, Section 357(c) was applicable. The Commissioner's approach can be similarly applied to every cash basis taxpayer who transfers accounts receivable and accounts payable. Obviously, a cash basis taxpayer who transfers $100,000.00 of accounts receivable in exchange for the assumption of $50,000.00 of accounts payable and the receipt by him of stock valued at $50,000.00 has not been economically benefited nor has he received any money as a result of the transaction. It is a long recognized concept of tax law that the imposition of a tax presupposes the receipt of income and income under Section 61 of the Code necessarily requires that the taxpayer be benefited in an economic sense, or at least, be in an improved financial position. In Easson, the Tax Court stated:

> "It is a fundamental concept of income taxation to tax gain when its fruits are available for payment of the tax."(7)

Seemingly, the absence of economic benefit alone should be sufficient basis upon which to exclude Appellants' transfer from the impact of Section 357(c). However, when it is determined that Appellants did not economically benefit from the transaction, but in fact may suffer an economic detriment

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(7) 33 T.C. 963, Note footnote 8 at p. 970 (1960)

then, it should be clear that Section 357(c) does not apply. Assume that the receivables transferred are $100,000.00 and the payables assumed by the corporation are $50,000.00 and that stock is issued for the net equity, or $50,000.00. The basis of the stock received by the taxpayer transferor in exchange for the assets and the assumption of the liabilities must be determined under Section 358(a), the basis of Appellants' stock would be the same as the basis of the property exchanged, i.e., zero.[8] However, this basis must be increased by the amount of the gain realized on the transfer, or $50,000.00. Under Section 358(d), the Appellants are then required to reduce their basis in the stock by the amount of

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[8] Sec. 358(a) General Rule-- In the case of an exchange to which section 351, 354, 355, 356, 361, or 371(b) applies--

(1) Nonrecognition Property.-- The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged--

(A) decreased by--

(i) the fair market value of any other property except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by--

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other property-- The basis of any other property (except money) received by the taxpayer shall be its fair market value.

the liabilities assumed by the corporation, or $50,000.00.[9] The result of this computation is that the tax basis of the stock is zero and, assuming the stock was sold for its book value, the taxpayer would realize a taxable gain of $50,000.00 upon the sale of the stock. Appellant, therefore, will eventually pay two taxes. The first tax has been imposed as a result of the application of 357(c) to the liabilities assumed at the time of incorporation. The second tax will be paid when the stock is sold as a result of the application of Section 358(d), resulting in a reduction of the basis of the stock by the amount of the liabilities assumed. It is inconceivable that Congress could have intended this result.

A literal application of the statute will also cause and encourage distortions in the incorporations of going businesses, which distortions could not have been intended by Congress when it enacted this section. These distortions can best be illustrated by examining three hypothetical situations. These examples assume that the sole assets and liabilities of the predecessor sole proprietorship transferred to the controlled corporation are accounts receivable and related accounts payable and that the transferor uses the cash method of accounting for reporting its income.

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(9) Sec. 358(d) Assumption of Liability-- Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

1. The transferor could retain the accounts receivable, use the proceeds from the collection thereof to satisfy the accounts payable and any income taxes arising as a result of the collection of the receivables and thereafter transfer the net cash to the corporation. Obviously, this would be the most extreme example of distortion since it would be virtually impossible for a "going" business to incorporate on this basis since it would require that the business be suspended during the liquidation period. That Congress could not intend such a result was made clear when it enacted Section 112(k) of the 1939 Code.

2. He could, instead, transfer only the trade accounts receivable to his controlled corporation without any assumption of liabilities by the corporation. The incorporation itself would not be an income realizing event. The transferee corporation, regardless of its method of accounting, would be taxed on the accounts receivable when collected. P. A. Birren & Son v. C.I.R., 116 Fed.2nd 718 (7th Cir. 1940). The transferor, would be entitled to a deduction for the trade accounts payable when they were paid by him. Thus, the resulting distortion since the income generated by incurring the liabilities would be shifted to the transferee corporation while the benefit of the expense deductions would be retained by the transferor.

3. Alternatively, the transferor could retain the accounts receivable and transfer to the corporation only the

accounts payable. Under the rule of the Testor case, the transferor would apparently be taxable to the extent that the liabilities assumed by the corporation, since no assets were transferred. Section 357(c) would be applied and the transferor would pay a tax on the gain at that time. In addition, the transferor, being on the cash basis, would also be taxed upon the receivables when they were collected.

Although there are no reported cases, the Commissioner is now apparently attempting to prevent both the transferor and the transferee from deducting the accounts payable on the theory that the transferee may not deduct such payables since it did not incur the payables and the transferor may not deduct such payables, since it did not make the payment, and both must be present in order for a deduction to be allowed. Further, the Commissioner also is apparently attempting to tax the accounts receivable only to the transferee on the theory that he may not assign his income. Only where both the accounts payable and accounts receivable are transferred does it seem likely that the Commissioner's theories will be thwarted. However, the case at bar may effectively prevent the taxpayer from transferring both accounts receivable and accounts payable.

II.

ASSUMING SECTION 357(c) IS APPLICABLE TO THE INSTANT CASE, THEN THE TRADE ACCOUNTS RECEIVABLE MUST BE ASSIGNED A BASIS AT LEAST EQUAL TO THE AMOUNT OF THE TRADE ACCOUNTS PAYABLE ASSUMED BY THE CORPORATION.

The Tax Court found that "accounts receivable in the hands of a cash basis taxpayer have a basis of zero", citing *P. A. Birren & Son, Inc. v. Commissioner*, 116 Fed.2nd 718 (7th Cir. 1940). It is submitted that this finding was made without careful analysis of Appellants' argument with respect to the basis of accounts receivable. Appellants agree that, in theory, the accounts receivable of a cash basis taxpayer have a zero basis and that this proposition would yield the correct result in the usual situation where the taxability of the accounts receivable itself is in issue. This was the case in *Birren*. However, Appellants submit that the concept of a zero basis for accounts receivable while producing a satisfactory result in the *Birren* situation, has never been analyzed in terms of Section 357(c). Therefore, general principles of tax law should apply in determining the meaning of "adjusted basis" under this section.

In *Birren*, the Court made the following statement:

> "Birren, the transferor, *had the benefit of deductions for the cost of his sales in his tax returns filed for previous years*, and that under this method the full amount collected on the accounts receivable would have been income taxable as such to the transferor when received." (emphasis added)

The Court was there stating that since the taxpayer had deducted the accounts payable and had received a tax benefit from that deduction, he could not thereafter transfer the accounts receivable and expect to assign a basis to those receivables for the purpose of preventing them from being

taxed to the transferor when received. Here, both the accounts payable and the accounts receivable had been simultaneously transferred to the new corporation with the result that the ultimate taxability of the receivables and deductibility of the payables will lay with the transferee corporation. The Court in Birren recognized that the deduction of the accounts payable and the resulting tax benefit is inextricably wound up with the taxability of the accounts receivable. Thus, a cash basis taxpayer who buys goods on credit and then sells those goods on credit should receive a basis for the resulting accounts receivable until such time as he has received the benefit from the deduction of the accounts payable. Once this benefit is realized, then the accounts receivable can be assigned a zero basis. This argument definitely finds authority in Code Section 1012 and the regulations thereunder. Section 1012 provides that the basis of property shall be the cost of such property. Treasury regulations, Section 1.1012-1(a) state that cost is the amount paid for such property in cash or other property. Therefore, it is clear that the concept of cost is to be applied when determining the basis of property. It is also clear that in the ordinary course of a business operation, the cost of generating trade accounts receivable necessarily includes the cost of related trade accounts payable. This concept goes to the very nature of the credit system of business enterprises. The Court below misconstrued Appellants' argument in this regard as depending

on the proposition that the accounts receivable transferred to the corporation by Appellants were encumbered by liens which were in the amount of the accounts payable so transferred. The Court then ostensibly concluded that the Appellants' "lien theory" was not supported by facts, and that the argument had no merit. It is submitted to this Court that the proposition that trade accounts payable are the cost of generating trade accounts receivable is not dependent upon whether or not the receivables were a lien on the payables, but it is a logical business fact which fits squarely within the provisions of Section 1012.

The cases cited by the lower Court in support of the proposition that the receivables should be assigned a zero basis were decided on the theory of the Birren case and were decided with a view towards eliminating any tax avoidance which might result from the transfer of cash basis accounts receivable in reorganizations.[10] These cases generally follow the theory of Code Section 362(a), that in a 351 exchange the basis of property in the hands of the transferor carries over to the transferee. Had Congress contemplated the problems arising from the cash basis incorporation and, specifically, the problem here, then it could have easily resolved the question by a cross reference in Section 357(c) to Section 362. Such a cross reference would have been uncontroverted evidence that "adjusted basis" under Section 357(c) was to be construed as having the same

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(10) See Tax Court Decision, p. 15.

meaning as "basis" under Section 362(a). There is no such reference either in Code Section 357 or the regulations thereunder, to Code Section 362. Therefore, it is incumbent upon this Court to judicially construe the term "adjusted basis" found in 357(c) in light of the legislative and judicial history of Section 357 and in light of the unwarranted results which follow from its application to cash basis taxpayers. It is clear that the Tax Court erred in concluding that the language of Section 357(c) is "clear and unambiguous". To the contrary, the meaning of "adjusted basis" is obviously open to judicial construction. Appellants submit that the concept of a zero basis for cash basis accounts receivable has no application under Section 357 where the question is only whether or not the transfer of cash basis accounts receivable with a value in excess of related accounts payable should give rise to a taxable event. In this context, it is clear that the Birren case is authority for assigning the receivables a basis equal to the amount of the payables and the meaning of "adjusted basis" under Section 357(c) should be so construed by this Court.

III.

IF, UNDER THE CASH METHOD OF ACCOUNTING, A ZERO BASIS MUST BE ASSIGNED TO ACCOUNTS RECEIVABLE, THEN IT MUST FOLLOW THAT A CASH BASIS TAXPAYER'S ACCOUNTS PAYABLE ARE NOT "LIABILITIES" WITHIN THE MEANING OF SECTION 357(c).

The Tax Court's refusal to assign a tax basis to the

accounts receivable equal in amount to the accounts payable results in a tax balance sheet which could not have been intended under Section 357(c). The Tax Court's and the Commissioner's balance sheet for Appellants is as follows:

ASSETS

Cash	$ 1,045.40
Accounts Receivable	1,833.97
Prepaid Rent	125.00
Equipment	8,247.36
TOTAL ASSETS	$11,251.73

LIABILITIES & NET WORTH

Accounts Payable (assumed)	$37,719.78
Notes Payable (assumed)	8,273.03
TOTAL LIABILITIES	$45,992.81
DEFICIT	(36,741.08)
TOTAL LIABILITIES & NET WORTH	$11,251.73

By no stretch of the imagination is the above statement of financial position correct or in accordance with generally accepted tax and accounting principles. Appellants' business was not insolvent. The accounting balance sheet would properly reflect <u>both</u> the accounts receivable and the accounts payable. It was on the basis of the accounting balance sheet that Appellants received stock and a note, valued at approximately $41,000.00, in exchange for the business. The tax balance sheet necessarily must depend on the taxpayer's method of accounting. For tax purposes, accounts receivable are not recognized until collected and accounts payable are not recognized until paid. Treasury Regulations Section 1.446-1(c)(1)(i) provide that:

"Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income...are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made."

If the Tax Court and the Commissioner are to be sustained in their theory that the accounts receivable must be assigned a zero basis under the Appellants' method of accounting, then it must necessarily follow that this theory should be applied consistently to both sides of the balance sheet. That is, if the term "adjusted basis" is to be construed strictly in a tax accounting sense then, the term "liabilities" must also be construed in a tax accounting sense. In a tax accounting sense, accounts payable are not liabilities to a cash basis taxpayer. Hence, the only proper tax balance sheet would be one which omits both accounts receivable and accounts payable. This construction would be entirely consistent with the legislative and judicial history of the code section.

It is clear that in order to avoid the inequities to the cash basis taxpayer with respect to his transfer of accounts receivable and accounts payable, Section 357(c) can only be interpreted as applying to the transfer of accounts receivable and accounts payable by an accrual basis taxpayer. Only when applied to the accrual basis taxpayer, do these terms have clear meaning. In any event, it is illogical to interpret the code section as applying in one manner to accounts receivable and as applying in a totally different

manner to accounts payable. The only consistent approach is to either construe "adjusted basis" in a pure accounting sense which would result in assigning a basis to accounts receivable on the theory that they have a cost, i.e., the amount of the related accounts payable and to therefore treat the accounts payable as a liability under Section 357(c); or, to properly treat both in a tax sense as having no existence to the cash basis taxpayer until that moment in time when they are collected or paid.

IV.

IN CASES OF DOUBT, STATUTE, OR INTERPRETED OR RESOLVED MOST STRONGLY AGAINST THE GOVERNMENT AND IN FAVOR OF THE TAXPAYER.

If doubt exists as to whether or not 357(c) should be applied to the facts in this case, such doubts should be resolved in the favor of taxpayer. This is a well-established rule of statutory construction and if a doubt exists as to whether or not the transfer of accounts receivable and accounts payable by a cash basis taxpayer under Section 351 comes within the purview of Section 357(c), such doubt should be resolved in favor of the taxpayer. In Gould v. Gould, 245 U.S. 151 (1917) the Court there stated:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen. Accord: Charles Leich & Co. v. United States, C. A. 7 (1954) 210 F. 2d 901, 907."

CONCLUSION

For the reasons herein stated, it is respectfully submitted that this Court should reverse the U. S. Tax Court decision, and that the cause be remanded to the United States Tax Court with directions to the parties hereto to submit computations under Rule 50 of the Tax Court in accordance with the decision of this Court.

All of which is respectfully submitted,

CLARENCE J. FERRARI, JR.

Attorney for Petitioners-Appellants

July 29, 1967